



DEPARTMENT OF GENERAL SERVICES'
DIVISION OF REAL ESTATE SERVICES
AND THE
OFFICE OF FISCAL SERVICES

REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2022

Auditor of Public Accounts
Staci A. Henshaw, CPA

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AUDIT SUMMARY

Our audit of the real estate leases administered by the Department of General Services' (General Services) Division of Real Estate Services (Real Estate Services) and accounted for by the Office of Fiscal Services (Fiscal Services) for the year ended June 30, 2022, found:

- proper recording and reporting of all transactions, in all material respects, in the Real Estate Services' real estate management system and the Department of Accounts' Attachment 11, after adjustment for the misstatements noted in the finding "Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87";
- one matter involving internal control and its operation necessary to bring to management's attention that is considered to be a material weakness; and
- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported.

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INTERNAL CONTROL FINDING AND RECOMMENDATION

Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87

Type: Internal Control

Severity: Material Weakness

Repeat: No

The Department of General Services' Division of Real Estate Services (Real Estate Services) real estate management and leasing system is not fully compliant with Governmental Accounting Standards Board (GASB) Statement No. 87, Leases. Real Estate Services did not adequately involve Department of General Services' Office of Fiscal Services (Fiscal Services) during the design and implementation stage of the real estate management and leasing system upgrade, including designing the year-end financial reports to ensure the system would properly and accurately report all necessary financial information. The real estate management and leasing system is deficient in the following areas:

- The system does not record leases by asset categories, such as land and infrastructure associated with real estate leases.
- The system does not separate out and record multiple asset components within a lease, such as a split lease containing land and building assets. As a result, Fiscal Services inappropriately reported all right-to-use intangible assets as buildings in the capital assets footnote. Real Estate Services must re-evaluate their leases for multiple components or components other than buildings in order to determine the impact within the footnote disclosure.
- The system does not have a field to record or determine lease classification, such as short-term lease, long-term lease, finance purchases, and non-exchange like transactions. The Leased Real Property Team and Fiscal Services determines the lease classification manually outside of the system.
- The data requires numerous manual manipulations outside the system to prepare the financial reporting information, which include:
 - Calculating the non-lease component of the total lease payment.
 - Applying the \$50,000 threshold to determine short-term leases.
 - Reversing and correcting previously remeasured leases when errors occur.

In addition, due to staff turnover in both Real Estate Services and Fiscal Services prior to fiscal year end, there was a lack of communication between divisions. The current directors and staff of Real Estate Services and Fiscal Services improved communication and worked together to obtain a complete

understanding of the complex intricacies of GASB Statement No. 87 financial reporting requirements and finalize policies and procedures but were unsuccessful, resulting in the following errors:

- Real Estate Services inappropriately used the prime interest rate for 287 pre-existing leases instead of using their incremental borrowing rate, which they appropriately used for all new leases. The prime rate was 3.15 percent to 10.05 percent less than the correct rate for each lease depending on the lease type and location. This error resulted in an overstatement of \$111.4 million for right-to-use intangible assets and \$100.6 million for total long-term liabilities.
- Real Estate Services used the wrong effective date to calculate the remeasurement of 11 leases totaling \$11.5 million. Real Estate Services calculated the liability as if the remeasurement occurred on the lease accounting standard implementation date instead of the actual date of remeasurement, resulting in an overstatement of the leased assets.
- Real Estate Services did not properly classify five new leases as long-term, resulting in an understatement of the lease liability and assets. They classified two leases as future lease commitments due to improper lease start dates, two leases as short-term due to the non-lease component calculation improperly excluding an unreasonable amount (99%) of the payments, and one lease as nonexistent because Real Estate Services did not report the lease to Fiscal Services for financial reporting.
- Fiscal Services did not properly eliminate the system journal entries and record the revised entry for the 11 manually corrected leases to report the correct current year liability and asset activity. As a result, Fiscal Services overstated liability and asset increases by \$15.6 million and \$14.9 million and understated liability and asset reductions by \$13.6 million and \$12.3 million, respectively.
- Fiscal Services incorrectly reported lease interest expense, totaling \$24.7 million, as an operating expense instead of a non-operating expense.
- Fiscal Services improperly excluded long-term principal payments in the rent expense line item, which resulted in a \$16.6 million misstatement.
- Fiscal Services inappropriately attributed the entire beginning net position restatement for the Property Management internal service fund to the GASB Statement No. 87 implementation without calculating what the adjustment should be or considering other reasons for the restatement.

Real Estate Services and Fiscal Services made numerous material misstatements throughout the various internal service fund financial statement template line items, including intangible right to use capital assets, long-term liabilities, amortization, rent, and interest expense as well as the associated footnote disclosures resulting in a material weakness in financial reporting. Reporting incorrect amounts

to Department of Accounts (Accounts) in the internal service fund financial statement template could lead to inaccurate financial information reported in the Commonwealth's Annual Comprehensive Financial Report (ACFR).

Management is responsible for designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial information that is free from material misstatement, whether due to fraud or error. GASB Statement No. 87 prescribes the applicable accounting standards surrounding the proper accounting and financial reporting for leases. Commonwealth Accounting Policies and Procedures (CAPP) Manual Topics 31205-31220 state all agencies must follow guidelines as required by GASB Statement No. 87, and users of the Commonwealth's lease accounting system should review the specific requirements of the statement. CAPP Manual Topic 31205 specifically states that the lessee should determine the discounted interest rate using the implicit or explicit rate in the contract or the lessee's estimated incremental borrowing rate prior to using the Commonwealth's default prime rate.

Real Estate Services and Fiscal Services should develop, implement, and regularly update policies and procedures over their lease process to ensure accurate and complete reporting. Real Estate Services and Fiscal Services should collaborate to update the real estate management and leasing system fields to be compliant with GASB Statement No. 87 and to ensure the system enables reasonable and accurate reporting of lease financial information. Real Estate Services and Fiscal Services should determine how to identify lease variable costs not already included in the lease liability. Real Estate Services should re-evaluate all leases to ensure the non-lease components are reasonable and proper recording of all asset types. Real Estate Services should update the real estate management and leasing system for all calculations and determinations made outside of the system to accurately track, record, and report all leases in future years. Real Estate Services should ensure Fiscal Services has access to all of the information it needs to prepare Accounts' attachments such as the internal service fund financial statement template. Fiscal Services should maintain support for and make certain that the calculation for the fiscal year lease line items, footnotes, and disclosures are accurate prior to submitting this information to Accounts for use in the ACFR.

AGENCY HIGHLIGHTS

Real Estate Services is the Commonwealth of Virginia's provider of real estate services to state agencies. Some of Real Estate Services responsibilities include:

- management of the Commonwealth's real estate portfolio;
- comprehensive transactional support for buying, selling, leasing, and conveying real estate interests of the Commonwealth;
- transactional documentation preparation; and
- real estate information database maintenance, reporting, and enhancement.

Real Estate Services is a division of General Services. Real Estate Services leases over 4.8 million square feet of rental space. In fiscal year 2022, Real Estate Services managed 279 master long-term leases and 228 master short-term leases. Real Estate Services makes all lease payments to the lessor on behalf of the state agencies. In fiscal year 2022, Real Estate Services paid \$56.5 million in lease principal and interest payments. Real Estate Services recorded a net of \$294.5 million in right-to-use assets and \$307.0 million in long-term lease liabilities, with \$15.4 million being due within one year. In addition, Real Estate Services has \$21.0 million in future commitments for leases starting in fiscal year 2023.

Real Estate Services provides Fiscal Services with lease data from its real estate management and leasing system. Fiscal Services uses the lease data to report the transactions and year end asset and liability balances related to short-term leases, long-term leases, and financed purchases on the internal service fund financial statement template, Attachment 11, in compliance with GASB Statement No. 87. Fiscal Services submits this to the Department of Accounts in support of the Commonwealth's Annual Comprehensive Financial Report.

In 2017, the GASB issued Statement No. 87, *Leases*. GASB postponed the effective date of this accounting standard by 18 months by Statement No. 95, *Postponement of the Effective Dates of Certain Authoritative Guidance*. It was effective for fiscal year 2022 and significantly changed the way governments account for leases. Under the new complex model, operating and capital leases no longer exist, and governments are required to report all leases as financing transactions, which results in recording an intangible right-to-use asset and a liability for every lease except short term leases (less than 12 months or under the \$50,000 financial reporting threshold). GASB Statement No. 87 requires that governments recognize and measure existing leases using the facts and circumstances that exist at the beginning of the period of implementation, which was July 1, 2021, not the inception of the lease.



Staci A. Henshaw, CPA
Auditor of Public Accounts

Commonwealth of Virginia

Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 5, 2022

The Honorable Glenn Youngkin
Governor of Virginia

Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Department of General Services' Division of Real Estate Services and the Office of Fiscal Services** related to real estate leases for the year ended June 30, 2022. We conducted this audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, in support of the Commonwealth's Annual Comprehensive Financial Report audit. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our audit's primary objective was to evaluate the accuracy of General Services' financial transactions related to leases as reported in the Annual Comprehensive Financial Report for the Commonwealth of Virginia for the year ended June 30, 2022. In support of this objective, we evaluated the accuracy of recorded financial transactions in Real Estate Services' real estate management system and Department of Accounts' Attachment 11; reviewed the adequacy of Real Estate Services' and Fiscal Services' internal control; and tested for compliance with applicable laws, regulations, contracts, and grant agreements.

Audit Scope and Methodology

General Services' management has responsibility for establishing and maintaining internal control and complying with applicable laws, regulations, contracts, and grant agreements. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws, regulations, contracts, and grant agreements.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

- Leases

- Financed purchases

- Rent, insurance, and other related charges

- Interest expense

- Information system security over Real Estate Services' real estate management system

- System access controls over Real Estate Services' real estate management system

We performed audit tests to determine whether Real Estate Services' and Fiscal Services' controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws, regulations, contracts, and grant agreements. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of Real Estate Services' and Fiscal Services' operations. We tested details of lease classification and performed analytical procedures to achieve our objectives.

A nonstatistical sampling approach was used. Our samples were designed to support conclusions about our audit objectives. An appropriate sampling methodology was used to ensure the samples selected were representative of the population and provided sufficient, appropriate evidence. We identified specific attributes for testing each of the samples and, when appropriate, we projected our results to the population.

Our consideration of internal control over financial reporting (internal control) was for the limited purpose described in the section "Audit Objectives" and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the section titled "Internal Control Finding and Recommendation," we identified a deficiency in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the deficiency titled "Improve Internal Controls Over Financial Reporting of Leases under GASB Statement No. 87," which is described in the section titled "Internal Control Finding and Recommendation," to be a material weakness.

Conclusions

We found that Real Estate Services and Fiscal Services properly stated, in all material respects, the amounts recorded and reported in the Real Estate Services' real estate management system and Department of Accounts' Attachment 11, after adjustment for the misstatements noted in the finding "Improve Internal Controls over Financial Reporting of Leases under GASB Statement No. 87." The financial information presented in this report came directly from the Real Estate Services' real estate management system.

We noted a matter involving internal control and its operation that requires management's attention and corrective action. This matter is described in the section titled "Internal Control Finding and Recommendation."

Since the finding noted above has been identified as a material weakness, it will be reported as such in the "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards," which is included in the Commonwealth of Virginia's Single Audit Report for the year ended June 30, 2022. The Single Audit Report will be available at www.apa.virginia.gov in February 2023.

Exit Conference and Report Distribution

We discussed this report with General Services' management at an exit conference held on January 11, 2023. Government Auditing Standards require the auditor to perform limited procedures on management's response to the finding identified in our audit, which is included in the accompanying section titled "Agency Response." Management's response was not subjected to the other auditing procedures applied in the audit and, accordingly, we express no opinion on it.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

Staci A. Henshaw
AUDITOR OF PUBLIC ACCOUNTS

DBC/clj



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January 20, 2023

Staci Henshaw
Auditor of Public Accounts
P.O. Box 1295
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Dear Ms. Henshaw:

Thank you for the opportunity to respond to the Auditor of Public Accounts' Review of the Department of General Services' Division of Real Estate Services for the fiscal year ended June 30, 2022. Overall, we agree with the report's findings regarding our agency.

The Department of General Services will take necessary actions to address the internal control deficiencies identified in the audit report. We will work to update our internal policies and procedures in accordance with your recommendations.

We appreciate the professionalism of your staff and thank you for working with us.

Sincerely,

A handwritten signature in black ink, appearing to read "J. F. Damico".
Joseph F. Damico

**DEPARTMENT OF GENERAL SERVICES
DIVISION OF REAL ESTATE SERVICES**

As of June 30, 2022

Joseph Damico
Director, Department of General Services

Sandra Gill
Deputy Director, Department of General Services

Sara Page
Controller, Department of General Services

Vacant
Director, Division of Real Estate and Facilities Management

Vacant
Director, Bureau of Real Estate Services